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Fixed-Rate Focus Could Spell Trouble For Smaller Banks

By Andy Peters
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Community bankers know they must prepare for an eventual rise in interest rates. One way to get ready involves making variable-rate loans, but that task is proving daunting for many banks.

Just ask Paul Erwin, chief financial officer at Nuvo Bank & Trust in Springfield, Mass., who says it is tempting to stick with fixed-rate loans because they produce immediate profits. “You can make profits today, even though the yield is low,” he says.

Banks can get in trouble if they are too reliant on fixed rate products, especially on longer-term loans, says Chris Marinac, an analyst at FIG Partners. Those banks will face significant pressure when the Federal Reserve Board ratchets up interest rates.

“You don’t want to have a bank making a disproportionate amount of eight- to 10-year loans that are fixed at 3.75%,” Marinac says. “When rates go up, they’re going to hop up a lot, by 150 or 200 basis points. You could really be mismatched.

Most large banks are well-positioned for Fed tightening, according to data from SNL Financial. At banks with at least $100 billion of assets, the median gap between short-term assets and short-term liabilities, as a percentage of assets, was 22% at Dec. 31.

It is a different story at small banks. The median gap at banks with less than $2 billion in assets was 5.6% at the end of last year.

Banks with a high percentage of short-term loans can react quickly to changing rates. Variable rates add even more flexibility.

Many small banks are struggling with the issue. “It’s a two-edged sword,” Erwin says. “If you fund short and book long, you get [a better short-term return]. But you would get killed if rates go higher.”

Regulators have long harbored concerns about interest rate risk. The Federal Deposit Insurance Corp., as part of a series of technical assistance videos, plans to include a program that focuses on managing interest rate risk.

“If rates went up today, you could have serious consequences,” Daniel Frye, the FDIC’s Boston area director, said during a Wednesday meeting of the agency’s advisory committee on community banking. “Not to the extent it would cause banks to fail, but it would put them in a position where it’s difficult to absorb credit costs.”

Many community banks could end up in a precarious position when rates rise, Marinac says. In recent annual reports, about 80 banks disclosed data on the mix of loans in their portfolios.

Of those, five banks reported that fixed-rate loans made up at least 85% of total loans, Marinac says. At Dec. 31, fixed-rate loans made up about 91% of the total loans at Bank of Marin Bancorp (BMRC) in Novato, Calif.

To be sure, banks can migrate their risk by relyng on shorter durations. They can also use interest rate swaps as a hedge.

“These hedges allow us to offer long-term fixed-rate loans to customers without assuming the interest rate risk of a long-term asset by swapping our fixed-rate interest stream for a floating-rate interest stream,” the $1.4 billion-asset Bank of Marin said in it’s annual report.

Bank of Marin spokeswoman Sandy Pfaff declined to comment further.

Swaps have limited use as a hedge. For instance, the $13 billion-asset IberiaBank (IBKC) uses interest swaps to cover less than half its fixed-rate loans, Marinac says. The Lafayette, La., company has roughly $3.6 billion in loans that it doesn't get hedge against. "They know you can't hedge everything because it's too expensive," Marinac says.

Smaller banks should remain cautious about hedging because of it's complexity. "You need to go into it with a well-though-out plan," Frye said. "You really need to get it right before you enter a hedging strategy."

Another problem is that many borrowers demand fixed rates to "lock in low-rate financing," says David Tobin, a principal at Mission Capital Advisors.

It is very hard for banks to turn away business when credit-worthy borrowers are hard to come by. "If I'm a bank with a lot of fixed-rate loans, the good news is that I'm making a tremendous amount of money today," Tobin says.

Plus, some fixed rate loans may be safe to hold when rates rise. "If you have a legacy fixed-rate book that had some credit issues, rising rates aren't going to affect [the portfolio] because those borrowers couldn't refinance anyway," Tobin Says.

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